

City of Midland, Michigan

Management's Discussion and Analysis

As management of the City of Midland (the "City"), we offer readers of the City's financial statements this narrative overview and analysis of the financial activities of the City for the fiscal year ended June 30, 2004. We encourage readers to consider the information presented here in conjunction with additional information that we have furnished in our letter of transmittal, the financial statements, and the notes to the financial statements.

Financial Highlights

- The assets of the City exceeded its liabilities at the close of the most recent fiscal year by \$164,425,579. Of this amount, \$41,166,542 (unrestricted net assets) may be used to meet the government's ongoing obligations to citizens and creditors.
- The government's total net assets increased by \$8,043,147 during the fiscal year. Governmental activities accounted for \$2,135,252 of this increase, while business-type activities accounted for \$5,907,895. The increases are primarily due to accumulating funds for system and infrastructure improvements.
- At the end of the current fiscal year, the City's governmental funds reported combined ending fund balances of \$63,737,824, an increase of \$8,144,363 in comparison with the prior year. Approximately 76 percent of this total, or \$48,294,508, is reserved for various purposes. Of the remaining unreserved balance, \$6,587,725 is designated for specific purposes, leaving an unreserved, undesignated balance of \$8,855,591.
- At the end of the current fiscal year, unreserved fund balance for the General Fund was \$5,619,677, or 16 percent of total General Fund expenditures (including transfers).

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the City's basic financial statements. The City's basic financial statements comprise three components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to the financial statements. This report also contains other supplementary information in addition to the basic financial statements themselves.

Government-wide Financial Statements

The government-wide statements are designed to provide readers with a broad overview of the City's finances, in a manner similar to a private sector business.

The statement of net assets presents information on all of the City's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the City is improving or deteriorating.

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Management's Discussion and Analysis (Continued)

The statement of activities presents information showing how the government's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (for example, earned but unused vacation leave).

Both of the government-wide financial statements distinguish functions of the City that are principally supported by taxes and intergovernmental revenues (governmental activities) from other functions that are intended to recover all or a significant portion of their costs through user fees and charges (business-type activities). The governmental activities of the City include general government, public safety, public works (highways and streets and other services), community development, sanitation, parks and recreation, library, airport, transportation, tax appeal defense, interest and agent fees, and other functions. The business-type activities of the City include a regional water distribution system, regional wastewater collection system, a sanitary landfill, a golf course, parking, and real estate rental (primarily two senior citizen housing facilities).

The government-wide financial statements can be found on pages 14-16 of this report.

Fund Financial Statements

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The City, like other state or local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds of the City can be divided into three categories: governmental funds, proprietary funds, and fiduciary funds.

Governmental Funds - Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on the near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements.

Because the focus on governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

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Management's Discussion and Analysis (Continued)

The City maintains 14 individual governmental funds. Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures, and changes in fund balances for the General Fund and the Major Street Fund, both of which are considered to be major funds. Data from the other 12 governmental funds are combined into a single, aggregated presentation. Individual fund data for each of these nonmajor governmental funds is provided in the form of combining statements elsewhere in this report.

The City adopts an annual budget for each of its governmental funds, except for the Cemetery and Capital Projects Funds. Budgetary comparison statements have been provided herein to demonstrate compliance with those budgets.

The basic governmental fund financial statements can be found on pages 17 through 20 of this report.

Proprietary Funds - The City maintains two different types of proprietary funds. Enterprise Funds are used to report the same functions presented as business-type activities in the government-wide statements. The City uses Enterprise Funds to account for water distribution, wastewater collection, sanitary landfill operations, downtown parking, senior citizen housing, and golf course operations. Internal Service Funds are an accounting device used to accumulate and allocate costs internally among the City's various functions. The City uses Internal Service Funds to account for equipment and fleet operations, data processing services, general and liability insurance, special assessment project funding, and bus garage operations. Because these services predominantly benefit governmental rather than business-type functions, they have been included within governmental activities in the government-wide financial statements.

Proprietary funds provide the same type of information as the government-wide financial statements, only in more detail. The proprietary fund financial statements provide separate information for the Water, Wastewater, Real Estate Rental, and Sanitary Landfill Funds, which are considered to be major funds of the City. The remaining Enterprise Funds and the Internal Service Funds are each combined into a single aggregated presentation in the proprietary fund financial statements. Individual fund data for the remaining Enterprise Funds and the Internal Service Funds is provided in the form of combining statements elsewhere in this report.

The basic proprietary fund financial statements can be found on pages 21 through 30 of this report.

Fiduciary Funds - Fiduciary funds are used to account for the resources held for the benefit of parties outside the government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of those funds are not available to support the City's own programs

The basic fiduciary funds financial statements can be found on pages 31 and 32 of this report.

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Management's Discussion and Analysis (Continued)

Notes to the Financial Statements - The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 33 through 67 of this report.

Other Information - In addition to the basic financial statements and accompanying notes, this report also presents certain required supplementary information concerning the City. This information can be found on pages 68-71 of this report.

The combining statements referred to earlier in connection with nonmajor governmental funds, nonmajor Enterprise Funds, and Internal Service Funds are presented immediately following the required supplementary information.

Government-wide Financial Analysis

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. In the case of the City, assets exceeded liabilities by \$164,425,579 at the close of the most recent fiscal year.

The largest portion of the City's net assets (68 percent) reflects its investment in capital assets (e.g., land, buildings, vehicles, equipment, and infrastructure), less any related debt used to acquire those assets that are still outstanding. The City uses these capital assets to provide services to citizens; consequently, these assets are not available for future spending. Although the City's investment in its capital assets is reported net of related debt, it should be noted that the resources need to repay debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

	Governmental Activities		Business-type Activities		Total	
	2004	2003	2004	2003	2004	2003
Assets						
Current and other assets	\$ 74,766	\$ 69,511	\$ 32,082	\$ 32,658	\$ 106,848	\$ 102,169
Capital assets	36,519	33,781	104,548	102,035	141,067	135,816
Total assets	111,285	103,292	136,630	134,693	247,915	237,985
Liabilities						
Current liabilities	8,185	6,904	5,151	6,329	13,336	13,233
Long-term liabilities	43,791	39,215	26,362	29,155	70,153	68,370
Total liabilities	51,976	46,119	31,513	35,484	83,489	81,603
Net Assets						
Invested in capital assets -						
Net of related debt	34,483	31,454	77,972	73,154	112,455	104,608
Restricted	9,586	5,324	1,219	1,219	10,805	6,543
Unrestricted	15,240	20,395	25,926	24,836	41,166	45,231
Total net assets	<u>\$ 59,309</u>	<u>\$ 57,173</u>	<u>\$ 105,117</u>	<u>\$ 99,209</u>	<u>\$ 164,426</u>	<u>\$ 156,382</u>

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Management's Discussion and Analysis (Continued)

An additional portion of the City's net assets (7 percent) represents resources that are subject to external restrictions on how they are to be used. The remaining balance of unrestricted net assets (\$41,166,542) may be used to meet the government's ongoing obligations to citizens and creditors.

At the end of the current fiscal year, the City is able to report positive balances in all three categories of net assets, both for the governmental and business-type activities as a whole, as well as for its separate governmental and business-type funds. The same situation held true for the prior fiscal year.

The government's total net assets increased by \$8,043,147 during the fiscal year. Governmental activities accounted for \$2,135,252 of this increase, while business-type activities accounted for \$5,907,895. The increases are primarily due to accumulating funds for system and infrastructure improvements.

	Governmental Activities		Business-type Activities		Total	
	2004	2003	2004	2003	2004	2003
Revenue						
Program revenue:						
Charges for services	\$ 3,661	\$ 2,741	\$ 19,937	\$ 18,360	\$ 23,598	\$ 21,101
Operating grants and contributions	5,266	4,705	-	-	5,266	4,705
Capital grants and contributions	1,575	1,678	1,682	2,358	3,257	4,036
General revenue:						
Property taxes	30,365	31,368	-	-	30,365	31,368
Intergovernmental	3,655	4,031	-	-	3,655	4,031
Investment earnings	1,223	1,234	461	475	1,684	1,709
Transfers, miscellaneous revenue, and special items	(1,515)	(1,674)	2,122	2,213	607	539
Total revenue	44,230	44,083	24,202	23,406	68,432	67,489
Program Expenses						
General government	3,924	3,279	-	-	3,924	3,279
Public safety	9,711	9,250	-	-	9,711	9,250
Public works	6,906	5,169	-	-	6,906	5,169
Community development	728	693	-	-	728	693
Sanitation	2,239	1,970	-	-	2,239	1,970
Parks and recreation	4,021	3,456	-	-	4,021	3,456
Library	4,395	4,334	-	-	4,395	4,334
Transportation	1,507	1,287	-	-	1,507	1,287
Tax appeal defense	4,532	5,361	-	-	4,532	5,361
Other functions	4,103	3,280	-	-	4,103	3,280
Interest on long-term debt	29	37	-	-	29	37
Water	-	-	7,361	7,561	7,361	7,561
Wastewater	-	-	4,469	5,049	4,469	5,049
Landfill	-	-	2,507	3,513	2,507	3,513
Golf course	-	-	984	1,035	984	1,035
Parking system	-	-	186	140	186	140
Real estate rental	-	-	2,787	2,375	2,787	2,375
Total program expenses	42,095	38,116	18,294	19,673	60,389	57,789
Change in Net Assets	\$ 2,135	\$ 5,967	\$ 5,908	\$ 3,733	\$ 8,043	\$ 9,700

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Management's Discussion and Analysis (Continued)

Governmental Activities

As mentioned above, governmental activities increased the City's net assets by \$2,135,252, due mostly to the Storm Water Management Fund, and the Downtown Development Authority Fund (DDA). The City is funding a \$2.5 million storm water collection system improvement project with a two-year millage. Approximately half of these dollars were collected during this fiscal year and are being held for construction in the 2004-2005 year. The DDA sold its interests in two limited partnerships: the Downtown Office Center Limited Partnership and the Larkin Building Limited Partnership. The proceeds from the two sales were \$453,613 greater than the recorded values of the investments. At year end, those funds were in cash equivalents in the DDA fund. A more detailed discussion follows:

- Charges for services revenue increased by \$919,091. Cable Communications franchise fees are included as charges for services in the current year, while \$444,311 was reported as general revenue in the prior year. Public safety revenue increased over the prior year by \$182,309 due to increased revenue from permits and district court fees. Library revenues increased by \$151,878, due to a catch-up payment from Midland County on the pass-through of penal fines.
- Operating grants and contributions revenue increased by \$560,911 over last year, with the largest areas of increase coming in public works (\$254,993) and community development (\$130,924). The increase in public works is due to the larger amount of gas and weight tax that was passed through to the City from the State of Michigan. The increase in community development is proportionate to the increase in the expenditures related to the Community Development Block Grant program. As a reimbursement-type program, additional expenditures result in greater earned revenues.
- Property tax revenue decreased by \$1,010,980. As discussed later in Note 17 of the notes to the financial statements section of this report, the City is reserving net assets to fund potential unfavorable outcomes in three major tax appeal cases. This reserve is recorded as a long-term liability on the government-wide financial statements. Accordingly, any tax revenues collected to fund this reserve are recorded as an increase to the liability, rather than as property tax revenue. As such, while property tax revenues as presented on the governmental funds statement increased from prior year, a portion was transferred to the reserve, thus reducing the remaining balance that is shown as revenue on the government-wide financial statements.
- Intergovernmental revenues decreased by \$375,239, mainly due to reductions in the amount of state-shared revenue being passed through to the City from the State of Michigan.

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Management's Discussion and Analysis (Continued)

- Certain factors impacted both governmental and business-type activities: the City's workforce includes six collective bargaining units that provide for an average wage increase of 3 percent; health insurance costs increased 16.5 percent; pension costs increased between 3 percent and 12 percent; and general and liability insurance increased by 20 percent. Also, a change in the allocation process of Internal Service Funds between governmental and business-type activities impacted both. Up until the 2004 fiscal year, the Special Assessment Revolving Fund was combined with the General Fund, thereby being reported 100 percent as governmental activities. For the 2004 year, it was separated from the General Fund, and is now allocated as an Internal Service Fund. The impact of this change resulted in an increase to governmental expenses of approximately \$1.3 million, with a decrease to business-type expenses by approximately the same.
- Certain public works construction projects, which were still included in "construction in progress" in the prior year, were further reviewed at closure and deemed to be "maintenance" in nature. Accordingly, these projects were expensed during the current year, rather than capitalized. This contributed to an increase in public works expenses over the prior year.
- Tax appeal defense costs decreased significantly because the City was between trials in the current year. The largest of the three major tax appeals was tried in fiscal year 2003, while the other two did not reach trial until after the close of the 2004 fiscal year.
- Other functions increased due to additional separation pay to several employees who retired during the fiscal year.

Business-type Activities

Business-type activities increased the City's net assets by \$5,907,895. Key elements follow:

- Charges for services increased by \$1,577,057 (9 percent) during the year. The increase was primarily due to a rate adjustment in the Wastewater Fund and increased usage of the sanitary landfill.
- Capital grants and contributions decreased by \$676,034 (29 percent). Most of the decrease was due to the completion of golf course improvements in the prior year, which were funded mostly by foundation contributions.
- Program expenses decreased from last year for water and wastewater activities by \$200,097 and \$581,025, respectively, due mostly to the change in treatment of the Special Assessment Revolving Fund, as previously discussed. Sanitary landfill program expenses decreased by \$1,006,045, mostly due to an adjustment to depreciation expense as a result of underestimating, in prior years, the capacity of cell #14, which was filled to capacity during the current fiscal year.

City of Midland, Michigan

Management's Discussion and Analysis (Continued)

Financial Analysis of the Governments Funds

As noted earlier, the City uses fund accounting to ensure and demonstrate compliance with finance-related requirements.

Governmental Funds - The focus of the City's governmental funds is to provide information on near-term inflows, outflows, and balances of spendable resources. Such information is useful in assessing the City's financing requirements. In particular, unreserved fund balance may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year.

As of the end of the current fiscal year, the City's governmental funds reported combined ending fund balances of \$63,737,824, an increase of \$8,144,363 over the prior year. Approximately 24 percent of this total amount (\$15,443,316) constitutes unreserved fund balance, which is available for spending at the government's discretion. The remainder of the fund balance is reserved to indicate that it is not available for new spending because it has already been committed to a variety of restricted purposes, with the largest reserve being for tax appeals (\$41,848,971). See Note 17 in the notes to the financial statements section of this report for more information on the tax appeals.

The General Fund is the chief operating fund of the City. At the end of the current fiscal year, unreserved fund balance of the General Fund was \$5,619,677, or 16 percent of total General Fund expenditures. The fund balance of the City's General Fund increased by \$4,184,254 during the current fiscal year. This is mainly due to additional property taxes, which were levied during the year ended June 30, 2004 to fund an increase to the fund balance reserved for tax appeal contingencies.

Proprietary Funds - The City's proprietary funds provide the same type of information found in the government-wide financial statements, but in more detail.

The Enterprise Funds operations for the current year resulted in an increase to net assets of \$4,535,045. The Water and Wastewater Funds had increases of \$1,906,348 and \$1,978,959, respectively. Both of these funds set their user fees to allow accumulation of reserves for capital investment and debt service. The increase in net assets reflects the result of this process. The Sanitary Landfill Fund had an increase in net assets of \$1,291,169. A portion of this was expected to fund future cell closure and development; however, the landfill received unanticipated revenue of approximately \$750,000 due to a neighboring township's disposal of contaminated soils.

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Management's Discussion and Analysis (Continued)

General Fund Budgetary Highlights

Differences between the original budget and the final budget were minimal. In general, total revenues and transfers in were greater than budgeted, and expenditures and transfers out were less than budgeted. Intergovernmental revenue and other revenue were less than the final budget, primarily due to the timing of grants and donation-funded expenditures. Public safety and public works were over budget by \$46,240 and \$51,690, respectively. In each case, personnel costs were higher than anticipated, causing the budget overage.

Capital Asset and Debt Administration

The City's investment in capital assets for its governmental and business-type activities as of June 30, 2004 amounts to \$141,066,495 (net of accumulated depreciation). This investment in capital assets includes land, land improvements, buildings, systems, machinery and equipment, streets, bridges, and sidewalks. The total increase in the City's investment in capital assets for the current fiscal year was \$5,250,759 (a 3.9 percent increase for both governmental and business-type activities).

Major capital asset events during the current fiscal year included the following:

- Construction continued on the water distribution system improvement to increase the water pressure in the northeast section of the City. Various other system additions and improvements were also completed.
- The City's replacement plan of vehicles and equipment continued.
- The sanitary landfill completed construction of cell 15.
- Numerous major and local street projects were completed during the fiscal year.

Additional information on the City's capital assets can be found in Note 5 on pages 49 through 52 of this report.

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Management's Discussion and Analysis (Continued)

City of Midland Capital Assets (in 1,000s of dollars)

	Governmental Activities		Business-type Activities		Total	
	2004	2003	2004	2003	2004	2003
Land	\$ 3,159	\$ 3,159	\$ 2,317	\$ 2,317	\$ 5,476	\$ 5,476
Construction in progress	6,885	6,439	3,559	9,530	10,444	15,969
Major and local roads	3,131	1,808	-	-	3,131	1,808
Sidewalks	76	-	-	-	76	-
Buildings and improvements	21,105	21,033	70,417	70,370	91,522	91,403
Land improvements	1,231	575	5,546	5,540	6,777	6,115
Water and sewer lines	-	-	66,473	56,533	66,473	56,533
Landfill improvements	-	-	9,794	6,754	9,794	6,754
Library circulation materials	6,401	6,565	-	-	6,401	6,565
Equipment	8,198	9,405	4,979	4,802	13,177	14,207
Vehicles	12,588	12,395	597	545	13,185	12,940
Total	62,774	61,379	163,682	156,391	226,456	217,770
Less accumulated depreciation	(26,255)	(26,226)	(59,134)	(55,728)	(85,389)	(81,954)
Total	<u>\$ 36,519</u>	<u>\$ 35,153</u>	<u>\$ 104,548</u>	<u>\$ 100,663</u>	<u>\$ 141,067</u>	<u>\$ 135,816</u>

Long-term Debt

At the end of the current fiscal year, the City had total bonded debt outstanding of \$26,960,886. Of this amount, \$19,850,886 comprises debt backed by the full faith and credit of the government. The remainder of the City's debt is backed solely by specified revenue sources.

City of Midland Outstanding Debt General Obligation and Revenue Bonds (in 1,000s of dollars)

	Governmental Activities		Business-type Activities		Total	
	2004	2003	2004	2003	2004	2003
General obligation bonds	\$ 385	\$ 520	\$ 19,466	\$ 20,839	\$ 19,851	\$ 21,359
Revenue bonds	-	-	7,110	8,500	7,110	8,500
Total	<u>\$ 385</u>	<u>\$ 520</u>	<u>\$ 26,576</u>	<u>\$ 29,339</u>	<u>\$ 26,961</u>	<u>\$ 29,859</u>

The City's total bonded debt decreased by \$3,054,124 during the fiscal year, reflecting the issuance of no new debt, coupled with timely principal payments.

The City maintains an AA rating with Standard and Poor's and an A1 rating with Moody's for the issuance of general obligation debt.

State statutes limit the amount of general obligation debt a government entity may issue to 10 percent of its total assessed valuation. Currently, 10 percent of assessed valuation is approximately \$270 million.

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Management's Discussion and Analysis (Continued)

Additional information on the City's long-term debt can be found in Note 9, on pages 55 through 57 of this report.

Economic Factors and Next Year's Budgets and Rates

Favorable information became available on two of the three major tax appeals in the form of a ruling from the Michigan Tax Tribunal on one appeal, and the exchange of appraisals on another, which improved the City's position in both appeals. As a result, the City was able to adjust its fund balance reserved for tax appeals downward and return the excess funds to the citizens in the form of a .68 millage credit applied to the July 2004 taxes. One of these two appeals was ultimately settled in October 2004, allowing the City to earmark approximately \$5 million of excess reserves to be returned to the citizens from the fund balance reserved for tax appeals of the General Fund. Note 17 of the notes to the financial statements provides additional information on the tax appeals.

Both the Water and Wastewater Funds' rates were increased for the 2004-2005 budget year. The rate increases were necessary as a result of operating cost increases, as well as to provide funding for future system expansion and improvements.

Requests for Information

This financial report is designed to provide a general overview of the City's finances for all those with an interest in the government's finances. Questions concerning the information provided in this report or requests for additional financial information should be addressed to the Finance Department at the Midland City Hall, 333 W. Ellsworth Street, Midland, MI 48640. Finance Department staff can be reached at 989-837-3322 or at cityhall@midland-mi.org. Additional information can be obtained at the City's website, www.midland-mi.org.